

Stop the Roller Coaster—A Smarter Approach to Apparel Sourcing

A Thought Leadership Report from AT Kearney

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Apparel retailers have been on a sourcing roller coaster for nearly 30 years. The 1980s brought a significant shift of manufacturing to China, where labor and raw materials cost less and were readily available. A few years later, quotas, labor practices and technological advancements spurred a need to find new low-cost countries, new sourcing partners, and new ways of designing and producing garments. Today, as factory capacity declines and raw-material costs and wages rise, retailers are looking for a smarter approach to apparel sourcing.

As the sourcing landscape changes, more retailers are chasing the last penny by trying to find new partners or countries to which to move production. But the problem is that all the new countries already have been “found,” and U.S. retailers are struggling with global labor-force changes and raw-material price volatility. Some now wonder whether the answer is to avoid the problems of international sourcing altogether and move production back (or at least closer) to the United States—bringing the roller coaster ride full circle.

There is no silver-bullet solution for today’s tough sourcing problems. But there are smart steps retailers can take to prepare for—and respond to—the market’s changing landscape.

Price and Supply Fluctuations

China is the largest exporter of apparel to the United States, accounting for more than 35 percent of total market share. The country is attractive due to its strong infrastructure, low production costs and easy access to an array of raw materials. But costs continue to rise in China as the exchange rate becomes less favorable, labor rates increase (along with inflation) and shipping becomes costlier (*see figure 1*). Factory closings and labor shortages in key production regions have led to higher prices and less capacity. Indeed, during this past season, factories canceled orders, catching many retailers by surprise and scrambling to find new suppliers or increase quantities on existing orders. Other countries, in Asia and elsewhere, are suddenly looking more competitive. (*see fig. 1*)

In addition, cotton prices reached an all-time high earlier this year as production struggled to meet demand and countries with excess cotton production (and sufficient domestic demand) were limiting exports. Just as fast as cotton prices increased, they have now returned to year-ago price levels. Other materials prices are also experiencing volatility—the price of petroleum-based fabrics, for example, rose by up to 20 percent. Fabrics once readily available now require longer lead times, and cut-and-sew vendors are sometimes asking for up-front payments to cover higher materials costs. Given the cotton spike from earlier this year, retailers were forced to decide how big an increase to pass along to consumers for the fall season, or whether to absorb some or all of the losses.

Weighing the Strategic Options

There are several options for overcoming these challenges; they include value-engineering garments, using more fabric blends or shifting to cheaper fabrics, taking early positions in fabrics, shifting sourcing to new countries, and, as a last resort, increasing prices.

Before exploring these various options, however, it is wise to first view the sourcing strategy within the context of your overall corporate strategy. Is the goal to be first to market on fashion items or to have the lowest prices? To sell only the highest-quality items or be the most sustainable? To market a particular “made in” designation? In any case, segmenting products by volume, style, complexity and destination country will help answer these questions and identify differentiated supply chains for key segments. Then, understanding the unique goals of each supply chain will help determine the right choices, and ensure sourcing portfolios are developed with an appropriate country mix and with strong supplier relationships. Retailers that create differentiated supply chains with diverse footprints are able to combat cost inflation while seeing only modest price increases.

Importantly, the current landscape is not temporary. China’s middle class continues to grow and, along with it, domestic demand. China will remain a key player in most sourcing portfolios, so the importance of rebalancing supply chains, expanding sourcing footprints and building three- to five-year sourcing plans cannot be overstated.

Exploring Lower-Cost Countries

Opportunities in low-cost countries should be evaluated from a total cost of ownership (TCO) perspective. This not only includes raw material costs, cut-make-trim (CMT) and duties, but also capabilities, quality, lead times, environmental impact, and inventory and markdowns. Taking a TCO perspective involves looking at today’s landscape and at all expectations of future costs and capabilities. Many countries can offer lower costs than China. For example, in Bangladesh, costs are as much as 15 percent lower than China’s; in India and Cambodia, costs are up to 10 percent lower (*see figure 2*).

These costs are already changing, however. Last year, the minimum wage for garment workers nearly doubled in Bangladesh after months of labor disputes—and more increases are possible, although, with India’s continued investment in textiles, Bangladesh’s access to raw materials will probably increase and offset the reduced labor advantage.

Beyond the TCO perspective, factors such as political stability and socioeconomic risks must also be considered. For example, Madagascar’s relatively low labor rates and duty-free status to the United States once looked attractive, but a 2009 political coup led to changes in duty-free status and altered the picture significantly. Unrest in Tunisia and Egypt has left retailers scrambling to address supply disruptions. The moral here is that the landscape is always shifting, which necessitates taking a portfolio approach for sourcing partners and countries, and using monitoring mechanisms to shift production appropriately.

Sourcing: A Portfolio Approach

You might be thinking that taking a portfolio approach is a no-brainer—obviously the concept of managing risk-reward is not new. However, many retailers know this and still have not acted on that information. There is a need not only to take a portfolio approach for managing manufacturing countries, but also for managing the supplier base.

We see three distinct supplier segments:

Lowest-cost suppliers. If basics or entry price-point items make up a significant portion of your assortment volume, it may make sense to shift some assortment to least-cost countries. Remember that lowest cost means lowest *total* cost (including duties, tariffs and quality control, among others). Over time, lowest-cost suppliers can become low-cost, stable suppliers. They must be monitored

regularly to ensure they make investments in machinery and staff in order to remain competitive and maintain quality.

Low-cost, stable suppliers. For updated basics with some level of complexity, maintaining some production with suppliers season after season may help ensure quality and supply continuity. And sampling costs will likely fall as suppliers gain a better understanding of their customers' needs. Test the market regularly, however, to ensure that these suppliers truly remain low cost.

Strategic suppliers. For complex products requiring new fabrication or finishing techniques, it is important to maintain a stable of suppliers that work collaboratively, contribute to the design process, and remain open to improving processes jointly. Such suppliers are worth investing in—they will go beyond the tangible elements to share an intangible “meeting of the minds” with a retailer’s design and supply-chain teams.

Maintaining the right supplier balance requires a supplier relationship management (SRM) program that reviews suppliers, sets joint targets, collaborates on big- and small-run items, and provides transparency and regular feedback to vendors.

A similar portfolio approach should be applied to source countries. Factors to consider include labor costs, access to and transportation costs for raw materials, factory efficiency and overhead rates, freight, duties and tariffs to destination country, design and talent capabilities, domestic demand, and political stability (*see figure 3*).

New York-based Coach recently announced plans to shift its accessories production from China to Vietnam and India, countries not known for producing accessories. But Coach management believe that Vietnam and India can provide low-cost, high quality and stable product supply. In four years, Coach hopes to reduce production in China from 80 percent to 50 percent. Tal Group, a Hong Kong-based apparel supplier, is working closely with its retailers on fabric innovations, developing wrinkle-free, stain-resistant, moisture-wicking and deodorant technologies, and prompting Brooks Brothers and Lands’ End to consider Tal as a strategic supplier.

A Word About Sourcing: Agents, Factories, Mills

The correct sourcing mix will vary for every retailer, based on overall corporate strategy and other factors. Sourcing through an *agent* can provide volume consolidation for smaller orders, a broader footprint, the ability to test new-product categories, and an in-country staff to handle issues quickly. Sourcing directly through *factories* can lead to more cost transparency and stronger relationships. (It can also help avoid some of the problems of working with an agent, such as a lack of understanding of the retailer’s business.) Going further back in the chain and sourcing fabrics from *mills* can increase cost transparency. Clearly, in low-volume categories it is usually more cost-effective to work with an agent, while in higher-volume categories it is more advantageous to work directly with the factory. Retailers that have introduced fabric platforming often take positions in fabric directly with mills.

Closer-to-Home Production

Moving production near- and on-shore can be part of the balanced strategy for certain product categories. Several near-shore countries, including Honduras, El Salvador and Mexico, are increasing their share of total U.S. imports, Haiti has also seen additional investment since the earthquake, although it remains a risky proposition. Advantages of near- and on-shore production include:

- Accelerating manufacturing and shipping lead times (by up to four weeks)
- Tapping into market trends with quick repeat orders
- Reducing inventory-planning misses
- Capturing “Made in America” branding benefits

In addition, favorable trade agreements and tariff exemptions make Central American countries particularly attractive for high-duty items. This is somewhat offset by higher production costs, sometimes 25 percent higher than in China. U.S. retailers can take advantage of duty-free imports from countries in the Central America Free Trade Agreement (CAFTA) by first exporting U.S. yarn or fabric to a CAFTA country; once production is complete, garments can enter the United States duty-free.

Los Angeles has replaced New York as the hub of U.S. apparel manufacturing, but New York’s Garment District has been revitalized and is still used by many high-end designers. For example, Nicole Miller manufactures half of its apparel in New York, while vF Corporation, Carhartt, Brooks Brothers, Dickie’s, Hanes Corporation and Lands’ End all maintain some level of U.S. production.

Stop the Ride

For years, China has been the place for apparel sourcing. But as the roller coaster ride slows down, the question now is how to get off. Should you be smart and weigh the strategic options? Explore lower-cost-country options? Evaluate closer-to-home production? Yes, yes, and yes. All options should be on the table. While the future of apparel sourcing might not be clear, one thing is perfectly apparent: The rapidly changing sourcing landscape—whatever direction it takes—requires a combination of strategic and analytical thinking and getting smarter about apparel sourcing.

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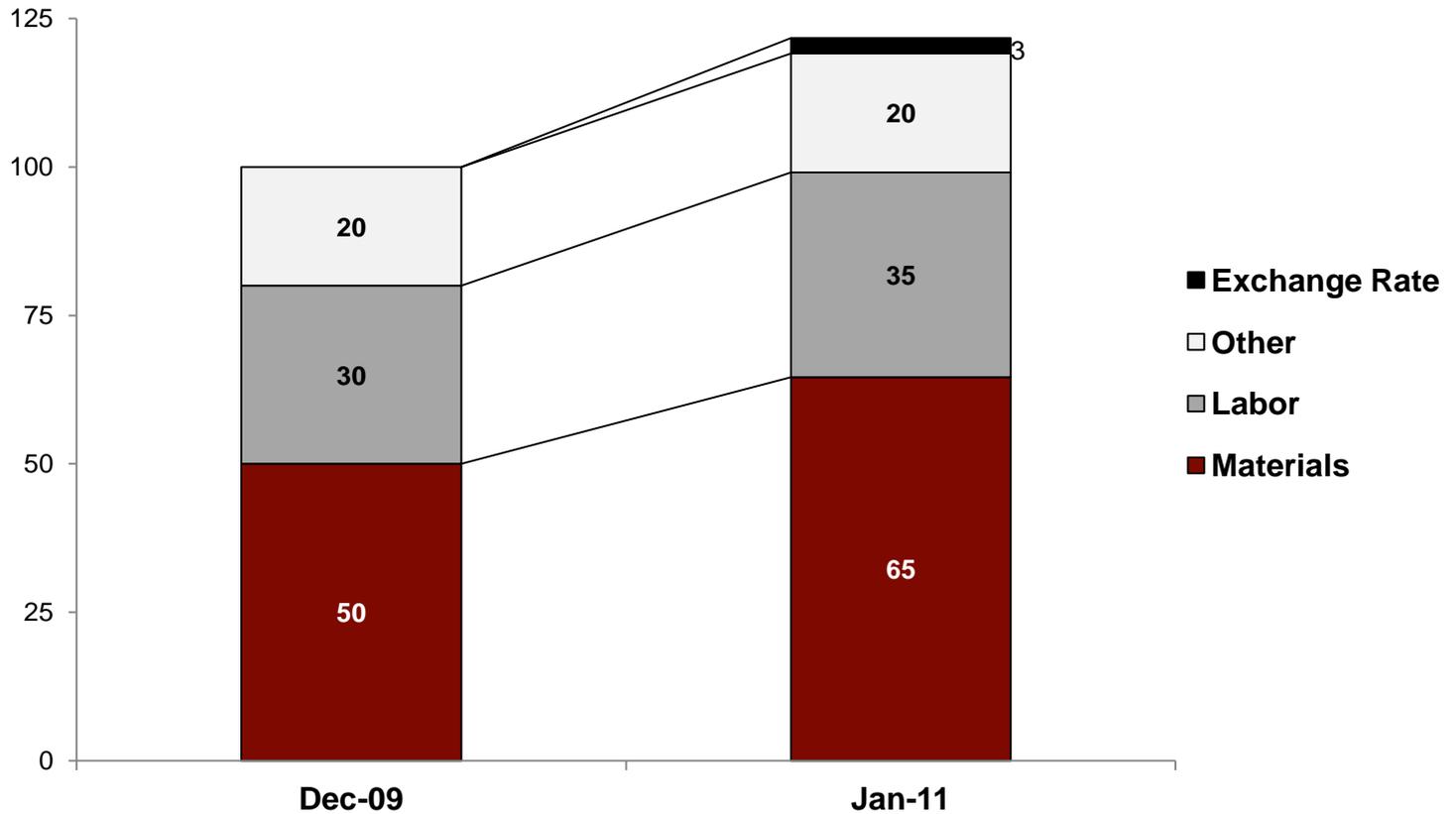
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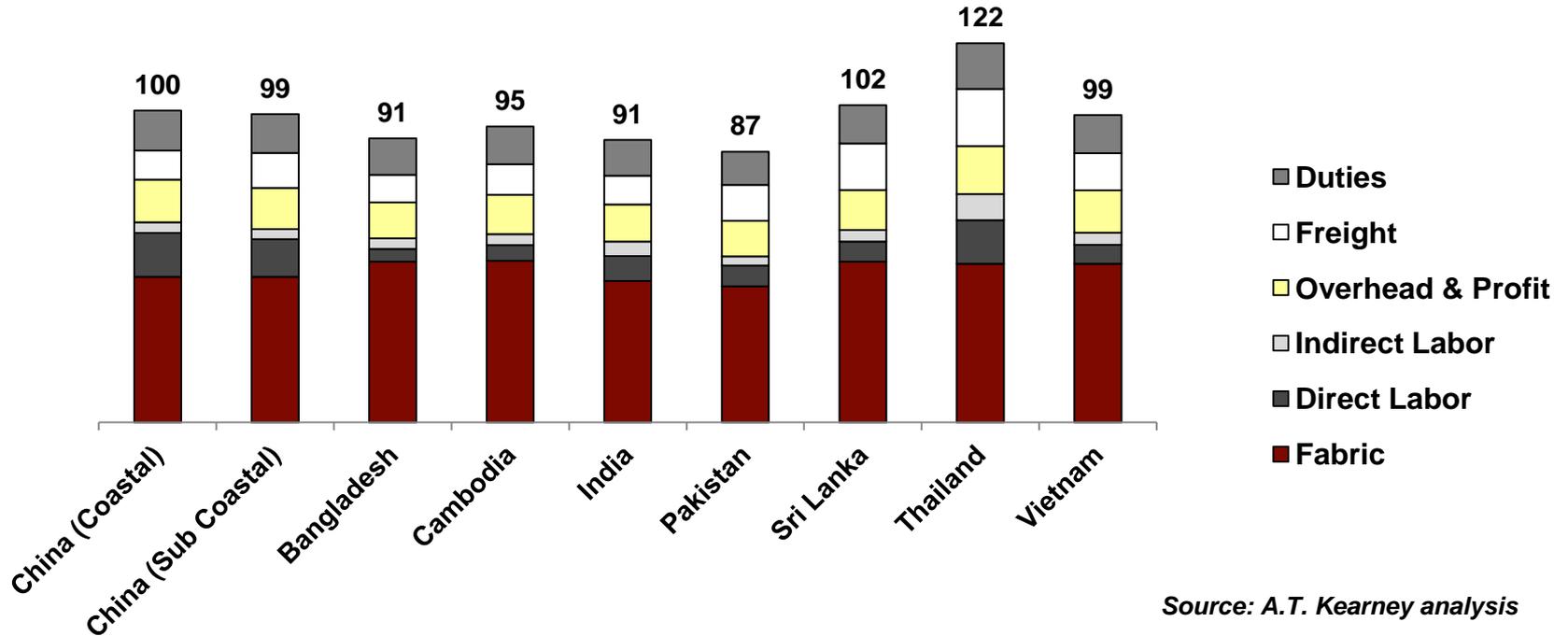
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Source: A.T. Kearney analysis

Figure 1: Sourcing costs in China are rising because of exchange rates, labor and materials

T-Shirt Product Costs across countries/regions (indexed to 100¹)



Source: A.T. Kearney analysis

Figure 2: Several countries offer lower costs than China

(1) China Coastal production cost was set to 100, all other countries/regions were indexed against the China Coastal production cost

Figure 3: Across production costs, there are numerous levers that apparel retailers can pull to drive efficiency including changing their country mix

Cost Element	Lever	Description	Potential FOB Benefits
Materials	Platforming	Rationalizing the number of fabrics used and communicating platforms to vendors can reduce costs and complexity by allowing vendors to plan and consolidate fabric purchases.	1-3%
	Yield Optimization	Using yield optimization software can lead to a decrease in fabric use and can provide additional negotiating power to buyers by allowing them to leverage yield information.	1-3%
Labor	Country Mix	Wage rates and labor efficiencies across different countries vary significantly and with constantly changing wages, it's important to ensure a balanced mix to decrease risk and exposure.	5-15%
	Cost Transparency	Arming buyers with detailed costing information, such as minutes required for sewing a garment, allows for should-cost based negotiations.	2-5%
Overhead	Factory Efficiency	Factory efficiency, including worker efficiency, factory floor layout, availability of utilities, and strength of management, can impact product cost.	Up to 8%
	Process Efficiency	Working with key vendors to streamline processes, such as sample requests and purchase orders, can have a positive impact on relationships and lead times.	1-4 weeks in lead time improvement
	Sample Costs	Sample costs are typically hidden within product cost but they are not insignificant. Implementing simple rules, such as checklists to comment on all aspects of a sample during every round and reviewing some samples using technology, can save costs over time and reduce approval lead times.	0.5-2% depending on adoption rate and average price point
Duties	Country Mix	Countries with duty-free (e.g., AGOA) or partial-duty (e.g., CAFTA) status can provide cost savings on products with high duties like synthetic t-shirts which have a 32% duty rate.	Up to 30% on applicable products
	Product Engineering	Duty rules are often complicated and slight changes in a garment can significantly adjust duties paid. For example, the difference in duties on a woven cotton pullover vs. a woven cotton blouse is 7.3% and the difference can be as simple as adding a waistband.	5-10% on applicable products
Logistics	Country Mix	Some countries provide advantages on shipping rates and lead times with near-shore countries providing the most advantage.	1-3% on landed cost and 1-4 weeks in lead time improvement
	Sourcing	With a strong focus on sourcing merchandise, opportunities to source logistics, which represents a lower cost overall but still can significantly impact total cost, is often forgotten.	1-2% on landed cost

Source: A.T. Kearney analysis